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IN THE

Supreme Court of the United States

OCTOBER TERM, 1963

No. 555

AMERICAN CAN COMPANY,
Petitioner,

v.

COMMISSIONER OF INTERNAL REVENUE,
Respondent.

PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SECOND CIRCUIT

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PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SECOND CIRCUIT

To the Honorable, the Chief Justice of the United States and the Associate Justices of the Supreme Court of the United States:

Petitioner, American Can Company, prays that a writ of certiorari issue to review the judgment of the United States Court of Appeals for the Second Circuit (by a panel consisting of Circuit Judges Clark, Smith and Hays) entered in the above case on May 29, 1963.

Opinions Below

The Opinion and Findings of Fact of the Tax Court (R. 15) are reported at 37 T.C. 198 (1961). The

opinion of the Court of Appeals for the Second Circuit (R. 165), which in part affirmed and in part reversed the decision of the Tax Court, is reported at 317 F.2d 604 (1963). The per curiam opinion of the Court of Appeals (Hays, Cir. J., dissenting in part) (R. 191), which denied a petition for rehearing, is unreported.

Jurisdiction

The judgment of the Circuit Court of Appeals was entered on May 29, 1963. Rehearing was denied on July 8, 1963. On October 1, 1963, this Court, by Mr. Justice Harlan, granted Petitioner's application for an order extending its time to file a petition for writ of certiorari to and including December 5, 1963. The jurisdiction of this Court is invoked under Section 1254(1) of the Judicial Code (28 U.S.C., § 1254(1)) and under section 7482(a) of the Internal Revenue Code of 1954.

Questions Presented

The following questions are presented for review:

(1) Whether the Commissioner may require an accrual basis taxpayer, for purposes of computing its federal income tax, to deduct vacation payments and property taxes in a year other than the year in which such items accrued, where the taxpayer had in prior years deducted similar items in the wrong period.

(2) Whether, under a proper construction of section 117(j) of the Internal Revenue Code of 1939 (now section 1231 of the Internal Revenue Code of 1954), the statutory phrase "property held by the taxpayer primarily for sale to customers in the ordinary course of his trade or busi-

ness" includes (a) property which a taxpayer acquired and held solely for use in its business and which it is compelled to liquidate under the terms of an antitrust decree and (b) property which a taxpayer holds chiefly or principally for the purpose of leasing to others and not for the purpose of sale.

Statutes Involved

The issue as to the taxpayer's right to deduct expenses in the year of their accrual involves section 41 of the Internal Revenue Code of 1939 (26 U.S.C., § 41, ch. 1, 53 Stat. 24 (1939)) and section 43 of the Internal Revenue Code of 1939 (26 U.S.C., § 43, ch. 1, 53 Stat. 24 (1939), as amended, ch. 619, 56 Stat. 830 (1942)). These sections are printed in full in the appendix hereto, *infra*, pp. A-1 - A-2.

The issue as to the proper construction of the phrase "property held by the taxpayer primarily for sale to customers in the ordinary course of his trade or business" involves section 117(j) of the Internal Revenue Code of 1939 (26 U.S.C., § 117(j), added by ch. 619, 56 Stat. 846 (1942), as amended, ch. 63, 58 Stat. 47 (1944), as amended, ch. 994, 64 Stat. 933 (1950), as amended, ch. 521, 65 Stat. 500 (1951)). This section is printed in full in the appendix hereto, *infra*, pp. A-2-A-4.

Statement of the Case

The court of first instance was the Tax Court of the United States which has jurisdiction to redetermine income tax deficiencies asserted by the Commissioner of Internal Revenue and to determine overpayments of income taxes imposed by the Internal Revenue Code

of 1939. Int. Rev. Code of 1939, §§ 272(e), 322(d) (26 U.S.C., §§ 272(g), 322(d)), ch. 1, 53 Stat. 83, 93 (1939)). The taxpayer's petition to the Tax Court sought such a redetermination and a determination that the taxpayer's income tax for 1953 had been overpaid.

This case presents two separate issues, *viz.*, the issue as to the year of deductibility of certain expenses and the issue as to the correct treatment of certain gains, which issues are related only by the fact that they both concern the same taxable year, 1953. Accordingly, the two issues will be stated separately.

The Accrual Issue

The taxpayer kept its books of accounts and filed its income tax return for the taxable year 1953 under an accrual method of accounting (R. 29). As of the end of 1953, and for several years prior, the taxpayer had in force written vacation plans for all its employees (R. 29). For all such years, including 1953, the taxpayer deducted on its federal income tax returns its vacation pay expense in the years when the vacation payments were made rather than in the preceding years when the liabilities therefor accrued (R. 29).*

Similarly, for all such years, including 1953, the taxpayer deducted on its federal income tax returns its New Jersey, Maryland, Louisiana and California property tax expenses in the years when such taxes were paid rather than in the preceding years when the liabilities therefor accrued (R. 30-31).* The property tax expenses for all other states were deducted by the tax-

* There is no issue in this case as to the year in which the items in question accrued, since the year of accrual is stipulated (R. 104, 105).

payer in the years when the liabilities therefor accrued (R. 31).

Thus, as the Tax Court found (R. 36-37):

> "Although petitioner kept its books and reported its income on an accrual system of accounting, it inconsistently deducted vacation pay and property taxes of four States (New Jersey, Maryland, Louisiana and California) on the cash basis, namely, in the year when it made the payments in question rather than in the year when the liabilities therefor accrued."

In 1957, the Commissioner asserted an income and excess profits tax deficiency for the year 1953 based upon his determination in respect of the capital gains issue discussed below. On August 5, 1957, within the period provided by statute, the taxpayer filed a petition with the Tax Court for the redetermination of such deficiency and sought, among other things, to correct its erroneous treatment of vacation pay and property taxes by deducting the amount of such items that accrued in 1953. Before filing its petition with the Tax Court, the taxpayer did not, of course, request the Commissioner's consent to claim the deductions which it had erroneously failed to claim in its return for the year 1953.*

---

* The parties stipulated that if it was held in the Tax Court proceedings that the taxpayer was entitled to deduct in 1953 the vacation pay and property taxes that accrued in that year, the vacation pay and property taxes that accrued in 1952 and which the taxpayer had claimed as a deduction in 1953 would be disallowed for 1953 (R. 104). The parties further stipulated that in the event of such disallowance for 1953 of the vacation pay and property taxes that accrued in 1952 and which were paid in 1953, the taxpayer would be allowed a deduction therefor in the year 1952, subject to compliance with the other provisions of sections 1311-14 of the Internal Revenue Code of 1954 (R. 104).

Relying on decisions of this Court, the Tax Court (in an opinion by Raum, J.) held that the taxpayer was entitled to correct its erroneous treatment of its vacation payments and property taxes, and to deduct in 1953 the amount of its liabilities for such items that accrued in 1953. The Tax Court further held that the Commissioner "confuses the issue by attempting to characterize the disputed revisions as a change in method of accounting" for which the Commissioner's permission was necessary (R. 40).

On appeal by the Commissioner, the Court of Appeals reversed the decision of the Tax Court on this issue. In its opinion (by Clark, Cir. J.), the Court of Appeals assumed, without discussion, that a change in accounting method was involved and held that a taxpayer must "consult with the Internal Revenue Service before making the change so that a distortion of taxable income overly detrimental to the Government will not result from the change" (R. 170).

The Capital Gains Issue

The taxpayer has been a leading manufacturer of metal and fiber containers for food and beverages and other products since 1901 (R. 16, 17, 55). As a necessary adjunct to its container business, the taxpayer manufactured closing machines and related and auxiliary equipment (collectively referred to herein as "closing equipment") for the closure of such containers (R. 17). From the outset, the taxpayer made such equipment available only by lease to its container customers at rents that were nominal (R. 17).

In 1946, the United States commenced an action against the taxpayer alleging violations of the antitrust laws and challenging in particular the taxpayer's system of requirements contracts for the sale of its containers and its practice of leasing its closing equipment only to container customers (R. 17, 59). Among other things, the amended complaint of the Government asked, in the alternative, for an order of divestiture of the closing machine part of the taxpayer's business or for an order directing the taxpayer to sell or lease its equipment to all applicants on non-discriminatory terms and conditions (R. 17-18). After a protracted trial, the case was decided in favor of the Government. (*United States v. American Can Co.*, 87 F. Supp. 18 (N.D. Cal. 1949)) The taxpayer succeeded in resisting the request of the Department of Justice for the complete divestiture of the closing equipment part of its business but was unsuccessful in resisting the drastic forced-sales provisions that the Department of Justice sought in the alternative (R. 18, 107-22).

The judgment entered in the antitrust suit (herein referred to as the "Judgment"), which became effective on January 1, 1951, directed the taxpayer to sell the closing equipment owned by it on that date (herein referred to as "pre-Judgment equipment") to all applicants at prices fixed by the Judgment (R. 110-14), and vested in the lessees of such equipment an absolute priority to purchase the equipment leased to them (R. 118-19). The Judgment also directed the taxpayer to offer to sell on non-discriminatory terms any closing equipment that it might acquire subsequent to such date (herein referred to as "post-Judgment equip-

ment") and to include options to purchase in leases of all its closing equipment (R. 110-11). In addition, the Judgment required the taxpayer to increase its rentals for all its closing equipment to a compensatory level by January 1, 1954 (R. 116). The sales of closing equipment in issue were made solely as a result of the Judgment entered in the antitrust action (R. 144-145, 148).

In its federal income tax return for the calendar year 1953, the taxpayer included the gains realized on the sales of closing equipment as gains from the sale of "property used in the trade or business" within the meaning of section 117(j) of the Internal Revenue Code of 1939. Under that statute the net gain from the sale of "property used in the trade or business" is treated as a long-term capital gain, but any net loss resulting therefrom is treated as an ordinary loss. The Commissioner determined that the gains on the taxpayer's sales of closing equipment should be taxed at ordinary rates on the theory that such equipment was held by the taxpayer "primarily for sale to customers in the ordinary course of [its] business" and therefore was not within the statutory definition of "property used in the trade or business."

The Tax Court sustained the Commissioner on this issue, holding, with respect to the pre-Judgment equipment, that it was immaterial that the taxpayer acquired and held such equipment solely for use in its business and sold such equipment only because the forced sale thereof was required under the terms of an antitrust decree. The Tax Court further held that the taxpayer's preference for leasing all its closing equipment should be ignored, since under the Tax Court's con-

struction of the statute, the exception in section 117(j) for property held "primarily" for sale to customers in the ordinary course of a taxpayer's business applies whenever a taxpayer has a "substantial" purpose to sell property, even though such purpose is not its "principal" or "chief" purpose in holding the property.

On appeal by the taxpayer, the Court of Appeals affirmed the decision of the Tax Court on this issue.

Reasons for Granting the Writ

I. The decision of the Court of Appeals, holding that the taxpayer was not entitled to deduct in 1953 the amount of its liabilities for vacation payments and certain property taxes that accrued in that year, is in direct conflict with this Court's decisions in *United States v. Anderson* and the long line of Supreme Court cases following that case, the most recent of which is *United States v. Consolidated Edison Co.*, holding that an accrual basis taxpayer must deduct its expenses in the year of accrual.

The taxpayer, which is on an accrual basis, seeks to deduct in 1953 the amount of its liabilities for vacation payments and certain property taxes that accrued in that year. As the Tax Court said, per Raum, J.:

> "The question before us is simply whether Petitioner is entitled to deduct in 1953 the liabilities which in fact accrued in 1953." (R. 37)

The Tax Court answered that question in the affirmative, stating:

> "We think the clear answer is that it may deduct these amounts in 1953, the year of accrual, in con-

formity with accrual principles of accounting, notwithstanding that it had uniformly treated such items incorrectly for an undisclosed number of prior years." (R. 37)

The Tax Court rested its conclusion on sections 23, 41 and 43 of the Internal Revenue Code of 1939 and the long line of Supreme Court cases, commencing with *United States v. Anderson*, 269 U.S. 422 (1926), that require an accrual basis taxpayer to deduct taxes and other expenses in the year of accrual. The Tax Court said:

> "The decisions recognizing that it is not open to an accrual basis taxpayer to treat selected items on a cash basis are almost too numerous for useful cataloging. It will suffice to refer to but several of them. In *United States v. Anderson*, 269 U.S. 422, it was held that an accrual basis taxpayer could not determine its true income without deducting all items of expense in the year in which such items accrued. *Anderson* specifically decided that a munitions tax which accrued in 1916 and was paid in 1917 must be deducted by an accrual basis taxpayer in 1916. The Court said (269 U.S. at 440):
>
> > 'The appellee's true income for the year 1916 could not have been determined without deducting from its gross income for the year the total cost and expenses attributable to the production of that income during the year. * * *'
>
> Since *Anderson* it has been the rule 'that a taxpayer who accounts on the accrual basis may, and should, deduct from gross income a liability which really accrues in the taxable year.' *Dixie Pine Products Co. v. Commissioner*, 320 U.S. 516, 519;

cf. *Security Flour Mills Co. v. Commissioner*, 321 U.S. 284; *United States v. Olympic Radio & Television*, 349 U.S. 232; *Heer-Andres Investment Co.*, 17 T.C. 786. Only recently the Supreme Court in *United States v. Consolidated Edison Co.*, 366 U.S. 380, 385, restated this principle in the negative as follows: '[N]either the Government nor an accrual-basis taxpayer may cause an item to be deducted in a year other than the one in which it accrued. [citing *Anderson, Security Flour Mills*, and *Olympic Radio & Television*].'

"Applying this rule to the present case, it is apparent that petitioner's practice of deducting the disputed vacation pay and property taxes of a few States in the years in which the liabilities were paid rather than in the years in which they accrued was erroneous because it was inconsistent with its overall accrual method of accounting. At least since the *Anderson* case, as an accrual basis taxpayer, petitioner was required to deduct these expenses (as it was all its expenses) in the year in which they were properly accruable. It seeks to accomplish this in the instant case. Given the respondent's admission that the disputed expenses accrued in 1953 in the amounts claimed by petitioner, we think the deductions must be allowed." (R. 38-39)

The Court of Appeals summarily reversed the decision of the Tax Court on this point. It did not disagree with the Tax Court's findings that taxpayer kept its books of account and reported its income on an accrual basis and that the liabilities in question for vacation payments and property taxes accrued in 1953. Nor did it challenge the Tax Court's statement that "[t]here is not even the slightest suggestion here that the accrual method of accounting, consistently applied,

would not clearly reflect Petitioner's income" (R. 38). It rested its decision solely on the proposition that the correction of errors in the treatment of significant items by a taxpayer "so as to bring the manner of accounting (sic) these items into accord with its general method" constitutes "a change in accounting method" which a taxpayer cannot make without the consent of the Commissioner. (R. 169)*

The Court of Appeals made no attempt to explain why the correction of an error should be thought to constitute a change in method of accounting. Nor did the Court of Appeals attempt to answer the reasoning of the Tax Court, which, in rejecting the Commissioner's contention that the repetition of an error can create an accounting method, said:

> "* * * we think respondent confuses the issue by attempting to characterize the disputed revisions as a change in method of accounting.
>
> "The correction of the erroneous treatment of these two items does not involve a change in accounting systems. Petitioner was on an accrual basis and the adjustments which it seeks would in no sense constitute a departure from accrual accounting; rather they would merely make these

* The so-called change in accounting method consisted, according to the Court of Appeals, in "a change in the taxpayer's accounting of local taxes and vacation pay from the cash basis to the accrual method * * *." (R. 169). The reference by the Court of Appeals to "the taxpayer's accounting of local taxes" implies that the taxpayer accounted for all local taxes on a uniform basis. But, as the Tax Court found, with the exception of the four states mentioned above, the taxpayer's deductions for local taxes were taken in the years when liability for such taxes accrued rather than in the years when such taxes were paid. (R. 31)

items conform to its system of accrual accounting. * * *

* * * * *

"The contrary view would in effect sanction hybrid accounting practices and would treat as a 'system of accounting' a mixture of accrual and cash items. * * *

* * * * *

"* * * by seeking to deduct the vacation pay and State property tax expenses in the taxable year in which they accrued, petitioner is attempting to perfect its accrual method of accounting, to eliminate the errors which have existed therein. The fact that these errors had gone uncorrected during prior years does not make them less erroneous in the taxable year under consideration nor does it make the need for their correction less immediate. * * *

* * * * *

"Neither estoppel nor any other principle of law is operative to prevent petitioner's 1953 taxes from being correctly computed under the statute.

"It has been clear, at least as far back as the *Anderson* case, that corrections of individual items to conform to the taxpayer's basic system of accounting are not discretionary either for the taxpayer or the Commissioner. See *Security Flour Mills Co. v. Commissioner*, 321 U.S. 284, where the Supreme Court said (pp. 285-287): * * *

" * * The uniform result has been denial both to government and to taxpayer of the privilege of allocating income or outgo to a year other than*

the year of actual receipt or payment, or, applying the accrual basis, the year in which the right to receive, or the obligation to pay, has become final and definite in amount. * * *" [Emphasis the Tax Court's.]

Similarly here, the corrections under consideration are necessary for the determination of petitioner's true income under an accrual method of accounting, and it is a matter of no moment whether such corrections are sought by the Government or the taxpayer." (R. 40-45)

The opinion of the Court of Appeals not only contains no discussion of the reasoning of the Tax Court but fails to discuss any of the controlling statutes, regulations or decisions of this Court that are relied on by the Tax Court, except for an attempt to distinguish *United States v. Consolidated Edison Co., supra.* Among the cases that the Court of Appeals ignored are two involving this taxpayer, *viz., United States v. American Can Co.*, 280 U.S. 412 (1930) and *American Can Co. v. Bowers*, 35 F.2d 832, 62d Cir. 1929), *cert. denied*, 281 U.S. 736 (1930), where, as the Tax Court said, "the shoe was on the other foot," since it was the Commissioner "who insisted upon a change in the treatment of a particular item" (R. 40). Those cases held that the correction of an item improperly reported in a return, "whether the result of mere error or designed," did not constitute a change in the taxpayer's accrual "basis of keeping accounts." (280 U.S. at 419)

In the *Consolidated Edison* case, this Court unanimously affirmed a decision of the Second Circuit (Clark,

Cir. J. dissenting), upholding an accrual basis taxpayer which, without the Commissioner's consent, sought to correct its accounting treatment of property taxes that, for at least 13 years, it had erroneously deducted in the year paid rather than in the year accrued. The Court said, per Mr. Justice Whittaker:

> "It is settled that each 'taxable year' must be treated as a separate unit, and all items of gross income and deduction must be reflected in terms of their posture at the close of such year. *Burnet v. Sanford & Brooks Co.*, 282 U.S. 359; *Heiner v. Mellon*, 304 U.S. 271; *Guaranty Trust Co. v. Commissioner*, 303 U.S. 493; *Security Mills Co. v. Commissioner*, 321 U.S. 281. And the parties agree that, under the applicable federal statutes, neither the Government nor an accrual-basis taxpayer may cause an item to be deducted in a year other than the one in which it accrued. *United States v. Anderson*, 269 U.S. 422; *Security Mills Co. v. Commissioner, supra*; *United States v. Olympic Radio & Television*, 349 U.S. 232." (366 U.S. 380, at pp. 384-85).

The decision of the Court of Appeals in the instant case cannot be reconciled with *Consolidated Edison*. Both cases presented the identical question whether an item of expense is deductible by an accrual basis taxpayer in any year other than the one in which the expense accrues. In each case the taxpayer had erroneously followed the practice of deducting such expenses in the year of payment, rather than in the year of accrual, and did not secure the Commissioner's permission to correct this error. In each case the same provisions of the 1939 Internal Revenue Code applied.

The Court of Appeals attempted to distinguish *Consolidated Edison* from the present case solely on the following basis:

> "There the Commissioner contested Consolidated Edison's making a proposed change at all. Here the Commissioner is not necessarily opposed to the change in accounting method which the taxpayer wants to make; rather, he demands merely that taxpayer consult with the Internal Revenue Service before making the change so that a distortion of taxable income overly detrimental to the government will not result from the change." (R. 169-70)

But this distinction does not exist. In neither this case nor *Consolidated Edison* did the taxpayer secure the Commissioner's permission to correct the erroneous treatment of its property taxes, and in both cases the Commissioner litigated the taxpayer's right to correct the error. If, in this case, the Commissioner were not "opposed" to the correction by the taxpayer of its erroneous practice, he has had ample opportunity to signify that fact merely by dropping his opposition to the taxpayer's claim. Moreover, the Second Circuit's attempted distinction would lead to the absurd conclusion that the courts will permit a taxpayer to correct an error in a case where the Commissioner mistakenly thinks that the error does not exist but will not permit a taxpayer to correct an error where the Commissioner recognizes that the error does exist.

Furthermore, it is clear that at no time here relevant did the Commissioner, in the language of the Court of Appeals, "demand" that taxpayers "consult with him" before correcting errors of the kind in

question. Thus, in 1957, and again in 1958, the Commissioner published rulings to the effect that accrual basis taxpayers who had for 1953 and prior years erroneously deducted property taxes and vacation pay in the year of payment, rather than in the year of accrual, were not only entitled but required to correct their errors and to deduct in the year of correction only the vacation payments and property taxes that accrued in that year. Rev. Rul. 57-13, 1957-1 Cum. Bull. 552; Rev. Rul. 58-24, 1958-1 Cum. Bull. 318.* It was not until 1959, long after the taxable year here in question and the institution of this proceeding, that the Commissioner reversed the position that he had previously maintained and announced that the correction of an erroneous treatment of these items of expense would be deemed by him to constitute a change in method of accounting, requiring his permission. Rev. Rul. 59-285, 1959-2 Cum. Bull. 458.

Nor do the reasons for obtaining the Commissioner's consent to a change in accounting method apply to the correction of an error. As appears from the regula-

* In accordance with these rulings, the taxpayer entered into a stipulation with the Commissioner with respect to the disallowance for 1953 of the vacation pay and property taxes that accrued in 1952 and which were paid in 1953. That stipulation was approved by the Tax Court in the following passage of its opinion:

> "Finally, it should be noted that allowing petitioner the claimed accrued expenses in 1953 will not result in any double deductions for the vacation pay and State property tax items involved. The parties have stipulated that if petitioner should be allowed the deductions claimed, the expenses erroneously claimed on its 1953 return (which petitioner paid in 1953 but accrued in 1952) should not be allowed. We concur that this is appropriate and consistent with the views expressed herein; as an accrual basis taxpayer, petitioner is entitled to deduct only the expenses which are properly accruable in 1953." (R. 45)

tions concerning changes in accounting methods, a request for permission to change the taxpayer's method of accounting must be accompanied by a statement specifying "all amounts which would be duplicated or entirely omitted as a result of the proposed change." Treas. Reg. 118, § 39.41-2(c). The adjustments which the Commissioner may require as a condition to consenting to the change have to do with taking into account such amounts, but only such amounts. See *Commissioner v. O. Liquidating Corp.*, 292 F.2d 225, 230 (3d Cir. 1961), *reversing* 49 T.C.M. 754 (1960), *cert. denied*, 368 U.S. 898 (1961). (The rule is the same under section 481(a)(2) of the Internal Revenue Code of 1954.) However, where, as here, an item deducted in the wrong year is moved to the right year, there is no amount which is either duplicated or entirely omitted. The item in question is deducted in one year, and only in one year. The only change is in the year of deduction. Accordingly, in the case of the correction of such an error, there is no question of adjustment for omitted or duplicated items for the Commissioner to consider.

Moreover, it is clear that the taxpayer will gain no advantage from making, and then correcting, its error. By reason of having deducted its vacation pay and property tax expenses one year later than it should have, the taxpayer has been paying a tax each year on fictitious income created by deferring such expenses from one year to the next. By relieving the taxpayer from paying a tax on such fictitious income, the Tax Court's decision would merely put the taxpayer in the position that it would have been in if it had previously

reported correctly. As shown above, that was the effect of this Court's decision in the *Consolidated Edison* case.*

The Court of Appeals relied solely on *Commissioner v. O. Liquidating Corp., supra*, and on *Wright Contracting Co. v. Commissioner*, 316 F.2d 249 (5th Cir. 1963), *affirming* 36 T.C. 620 (1961), *cert. denied*, 84 Sup. Ct. 147 (1963). In *O. Liquidating*, the Third Circuit reversed a decision of the Tax Court (19 T.C.M. 154 (1960)) holding that an accrual-basis taxpayer which had been including insurance dividends in income in the wrong year could include such items in income in the proper year in accordance with its method of accounting, without first securing the Commissioner's consent. Judge Forman dissented from the Third Circuit's decision in *O. Liquidating* and would have followed *Beacon Publishing Co. v. Commissioner*, 218 F.2d 697 (1955), where the Tenth Circuit held, on the authority of this Court's decision in *United States v. American Can Co., supra*, that

> "a taxpayer may, without the consent of the Commissioner, apply the method of accounting which he has adopted, though not theretofore applied to a particular item, when that change will correct errors and clearly reflect his income." (218 F.2d 697, at p. 702)

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* The holding of this Court in *Consolidated Edison* was made notwithstanding the fact that, because of differences in tax rates in the year of accrual and in the earlier years of payment, correction of the error by the taxpayer would result in the payment of substantially less taxes, over all, to the Government, and the further fact that the correction resulted in reducing the income of a single year by approximately $13,000,000, which reduction would otherwise have been spread over a five-year period. See Consolidated Edison Co. v. United States, 279 F.2d 852, 858 (2d Cir. 1960).

The decision of the Third Circuit in *O. Liquidating* was reached without the benefit of this Court's decision in *Consolidated Edison*. Moreover, the decision of the Third Circuit in *O. Liquidating* was considered by the Tax Court in the instant case and rejected in the light of this Court's decision in *Consolidated Edison*.

Wright Contracting is clearly distinguishable from the present case. In that case an accrual-basis contractor, which had in prior years included in income percentages retained out of progress payments under long-term contracts, reported retained percentages only in the year that the contract was completed. Both the Tax Court and the Fifth Circuit held that the taxpayer's original system of reporting the retainages was a proper method of accounting therefor and, accordingly, that such method could not be changed without the Commissioner's consent.

It is apparent that the opinion of the Second Circuit below is based on the philosophy of Judge Clark's dissent in *Consolidated Edison* when that case was before the Second Circuit. In his dissenting opinion, Judge Clark expressed the view that if "the precepts of accrual 'accounting'" are followed, taxpayers will be allowed undue liberty to choose the years in which expenses can be deducted, with the result that "ascertainment of the corporate income is substantially taken out of the hands of the revenue authorities." (279 F. 2d at pp. 157, 158).

Imaginary dangers of this kind, however, have not been thought sufficient by this Court to justify a departure from the "precepts of accrual accounting"

established by the statute and the earlier decisions. As this Court said in *Consolidated Edison:*

> "* * * under the applicable federal statutes, neither the Government nor an accrual-basis taxpayer may cause an item to be deducted in a year other than the one in which it accrued. * * *" (366 U.S. 380, at p. 385).

Petitioner submits that the decision of the Court of Appeals, reversing the Tax Court, is in direct conflict with this Court's decisions in *Consolidated Edison* and the long line of Supreme Court cases cited in that case. Accordingly, Petitioner urges that a writ of certiorari be granted with respect to this issue so that the prior holdings of this Court may be reaffirmed.

II. The holding of the courts below that the taxpayer should be denied the treatment provided by section 117(j) with respect to its gains on sales of closing equipment is based upon an erroneous construction of the statutory phrase "property held by the taxpayer primarily for sale to customers in the ordinary course of his trade or business" to include (A) property which a taxpayer acquired and held solely for use in its business and which it is compelled to liquidate under the terms of an antitrust decree and (B) property which a taxpayer holds chiefly or principally for the purpose of leasing to others and not for the purpose of sale.

The taxpayer is entitled to capital gain treatment on its gains from the sales of the closing equipment in issue because that equipment is within the statutory

definition of "property used in the trade or business," as set forth in section 117(j) of the 1939 Code:

> "* * * the term 'property used in the trade or business' means property used in the trade or business, of a character which is subject to the allowance for depreciation provided in section 23(l), held for more than 6 months, * * * which is not (A) property of a kind which would properly be includible in the inventory of the taxpayer if on hand at the close of the taxable year, or (B) property held by the taxpayer primarily for sale to customers in the ordinary course of his trade or business * * *."

There is no dispute that, at the time of sale, the closing equipment in issue was used in the taxpayer's trade or business, was property of a character subject to the allowance for depreciation, was not property of a kind which would properly have been includible in the taxpayer's inventory, and had been held for more than six months. The only question presented is whether such equipment was "held by the taxpayer primarily for sale to customers in the ordinary course of [its] trade or business."

The decisions below in effect hold that the 15,066 units of closing equipment that the taxpayer owned on the effective date of the Judgment, which it had held for an average period of more than 14 years solely for leasing to container customers, and which had been manufactured with no thought of sale, were immediately converted by the Judgment into property held primarily for sale to customers in the ordinary course of the taxpayer's business. This holding is made notwithstanding the fact that, under the Judgment, the

taxpayer was "ordered and directed to sell" its pre-Judgment equipment in accordance with a rigid system of priorities and at arbitrary prices established by the Judgment that were far below the value of the equipment, and the fact that the provisions of the Judgment were intended to, and in fact did, force a prompt liquidation of such equipment.

Even if the courts below were correct in holding under their construction of section 117(j) that the taxpayer held all its equipment "primarily for sale," the pre-Judgment equipment would still come within section 117(j), since, in view of the provisions of the Judgment, such equipment could not be considered as held for sale "in the ordinary course" of business. Any other construction of section 117(j) would deprive the statutory phrase "in the ordinary course of his trade or business" of any sensible meaning.

The Tax Court recognized that if sales of property used in a taxpayer's business occur under circumstances amounting to a "forced liquidation," as, for example, sales made pursuant to an order of divestiture, such sales "would not represent sales made in the ordinary course of business." (R. 35) The Court of Appeals agreed that in such case the taxpayer would "have been entitled to capital gain treatment without question." (R. 168) To that extent the courts below were on sound ground, because it is well established that a taxpayer is entitled to capital gain treatment under section 117(j) on the liquidation of property used in its business where such liquidation is precipitated by extraordinary circumstances involving legal or economic

compulsion.* The error of the courts below was in their failure to recognize that this principle applies with equal force to the sales of the taxpayer's pre-Judgment equipment pursuant to the terms of the Judgment.

The Judgment not only compelled the sale of such equipment, but dictated every significant term and condition governing the sale thereof and included an arbitrary pricing formula for the pre-Judgment equipment which resulted in prices that bore no relation to its value (R. 110-18). In short, the Judgment completely precluded the taxpayer from making a single significant business decision with respect to the disposition of the pre-Judgment equipment.

The Judgment was intended to force the liquidation of the taxpayer's pre-Judgment equipment (R. 18, 107-22), and in fact did so.** The Judgment accomplished this result by requiring the taxpayer to sell its pre-Judgment equipment (at bargain prices and in accordance with a strict system of priorities) on an

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* See, *e.g.*, Gudgel v. Commissioner, 273 F.2d 200 (6th Cir. 1959) (sales of grazing land over 5-year period prompted by extension of state road and other circumstances that rendered farming business uneconomical); Smith v. Commissioner, 232 F.2d 142 (5th Cir. 1956) (rental houses sold over 2-year period under purchase options vested in tenants pursuant to government regulations which also limited sales price); Chandler v. United States, 226 F.2d 403 (7th Cir. 1955) (trustees under duty to liquidate, sold real estate investments in hundreds of parcels over 35-year period at prices totaling more than $17,000,000); McGah v. Commissioner, 210 F.2d 769 (9th Cir. 1954) (sales of rental properties over 3-year period in order to reduce bank obligation).

** By the end of 1953, the third year after the Judgment became effective, only 30% of the 12,000 units of closing equipment that the taxpayer had owned prior to the effective date of the Judgment remained on hand, and five years after the Judgment became effective, only 10% of such equipment remained. (R. 24-25.)

installment basis, with installments comparable in amount to the greatly increased rentals which the taxpayer was required by the Judgment to charge for the use of such equipment (R. 73, 115-16). In fact, the great bulk of the pre-Judgment equipment was sold to lessees who had remained in continuous possession thereof since prior to the effective date of the Judgment. (R. 25, 26).*

For the foregoing reasons, it is submitted that, even if the taxpayer's pre-Judgment equipment could be deemed to be held with a primary purpose of sale, it could not be considered held primarily for sale to customers in the ordinary course of its business.

With respect to the post-Judgment equipment, as well as the pre-Judgment equipment, the taxpayer further submits that the courts below misconstrued the statutory language, "primarily for sale." Although it is undisputed that after the Judgment the taxpayer's "principal" or "chief" purpose in holding all its closing equipment continued to be to lease it, the

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*The question of the taxpayer's purpose in holding its pre-Judgment equipment is not affected by its purpose with respect to its post-Judgment equipment, whatever that purpose may have been. Even where a taxpayer's actions are not circumscribed by legal compulsion, it is clear that he may hold the same kind of property for entirely different purposes. Thus, it is well established that a taxpayer may hold property for investment or use in his trade or business but, though he holds the same kind of property for sale to customers in the ordinary course of his trade or business. Familiar examples are afforded by real estate dealers (Smith v. Commissioner, 232 F.2d 142 (5th Cir. 1956)), security dealers (Carl Marks & Co., 12 T.C. 1196 (1949)), livestock dealers (Robert B. Jewell, 25 T.C. 109 (1955)), automobile dealers (Latimer-Looney Chevrolet, Inc., 19 T.C. 120 (1952)), and dealers in other machinery and equipment (Differential Steel Car Co., 16 T.C. 413 (1951); Mary A. Browning, 9 T.C.M. 1061 (1950)).

Tax Court did not consider this circumstance material. That was because the Tax Court took the view that the statutory requirement of a primary purpose to sell is satisfied by something less than a "principal" or "chief" purpose, to wit, by a purpose which is merely "substantial" or "essential" (R. 33-35). Thus, since the Tax Court found that the taxpayer's purpose to sell its closing equipment was "substantial," it concluded that the taxpayer held the equipment "primarily for sale" within the meaning of the statute. The Court of Appeals also construed the statutory language in question

> "to comprehend property held with a purpose to sell that is 'substantial' or 'essential', even if not 'principal' or 'chief.'" (R. 167-68)

In construing the term held "primarily for sale" as they did, the Tax Court and the Court of Appeals followed a construction of section 117(j) which was first adopted in *Rollingwood Corp. v. Commissioner*, 190 F. 2d 263 (9th Cir. 1951), and which was subsequently accepted by the Second Circuit in *S. E. C. Corp. v. United States*, 241 F.2d 416 (2d Cir. 1957), *aff'g per curiam*, 140 F. Supp. 717 (S.D.N.Y. 1956), *cert. denied*, 354 U. S. 909 (1957), and by the Tax Court in *Joseph A. Harrah*, 30 T.C. 1236 (1958).

The difficulties with this construction are obvious, since the ordinary or normal meaning of the word "primarily" is, of course, "principally." (Webster's Third New International Dictionary (1963), p. 1800). Other courts have expressly refused to depart from the normal meaning of the word. Thus, in *United States v. Bennett*, 186 F.2d 407, 411 (1951), the Fifth Circuit

held that the phrase "primarily for sale" as used in section 117(j) means "the main, the first, purpose" of holding property. This construction was approved by the Court of Claims in *Herwig v. United States*, 105 F. Supp. 384, 390 (1952).*

Moreover, this Court has impliedly recognized that the term "primarily" is used in section 117(j) in its ordinary and normal sense. Thus, in *Massey Motors, Inc. v. United States*, 364 U.S. 92 (1960), where automobiles had been acquired by taxpayers with the expectation that they would be sold after use in a rental business for a substantially shorter period than their full economic life, this Court observed that "the 'profits' of the taxpayers here are capital gains and incur no more than a 25% tax rate." (364 U.S. at p. 97) In the dissenting and concurring opinion, Mr. Justice

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* In this connection, attention is called to the Report of the Senate Finance Committee with respect to section 274(a) of the 1954 Internal Revenue Code, added by the Revenue Act of 1962, which provides that no deduction shall be allowed with respect to a facility used in connection with entertainment, amusement or recreation unless, among other things, "the taxpayer establishes that the facility was *used primarily* for the furtherance of the taxpayer's trade or business." (Italics added.) With respect to the meaning of this clause, the Report of the Senate Finance Committee states:

> "Under the bill, if a facility is used more than one-half for business entertaining, so that more than one-half of the entertainment expense with respect to such facility would be deductible as a business expense under present law, that portion would continue to be deductible to the extent it meets the test of being directly related to (or associated with) the active conduct of the taxpayer's trade or business. If less than one-half of such entertainment expense would be deductible under present law, no deduction would be allowed." S. Rep. No. 1881, 87th Cong., 2d Sess., 31 (1962).

The standard of more than 50% usage has since been incorporated in the regulations issued by the Treasury with respect to the primary use test of section 274(a). Treas. Reg. § 1.274-2(e)(4)(iii) (1963).

Harlan said: "In the past the Commissioner, unsuccessfully, has merely sought to curb the capital-gains possibilities in such instances by contending that the automobiles involved were not depreciable assets subject to capital-gains treatment under § 117(j) of the Internal Revenue Code of 1939." (*Id.* at p. 118)

In view of the fact that this Court has not expressly ruled on the proper interpretation of the term "primarily for sale to customers in the ordinary course of his trade or business" as used in section 117(j) of the 1939 Code (and in section 1231 of the Internal Revenue Code of 1954), and in view of the conflict of opinion among the lower Federal courts as to the proper construction of this term, it is respectfully submitted that this Court should undertake to review the decision below on this issue.

CONCLUSION

For the foregoing reasons, this petition for a writ of certiorari should be granted.

Respectfully submitted,

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December, 1963

APPENDIX

STATUTES INVOLVED

INTERNAL REVENUE CODE OF 1939:

"SEC. 41. GENERAL RULE.

"The net income shall be computed upon the basis of the taxpayer's annual accounting period (fiscal year or calendar year, as the case may be) in accordance with the method of accounting regularly employed in keeping the books of such taxpayer; but if no such method of accounting has been so employed, or if the method employed does not clearly reflect the income, the computation shall be made in accordance with such method as in the opinion of the Commissioner does clearly reflect the income. If the taxpayer's annual accounting period is other than a fiscal year as defined in section 48 or if the taxpayer has no annual accounting period or does not keep books, the net income shall be computed on the basis of the calendar year."

(26 U.S.C., § 41, ch. 1, 53 Stat. 24 (1939))

"SEC. 43. PERIOD FOR WHICH DEDUCTIONS AND CREDITS TAKEN.

"The deductions and credits (other than the corporation dividends paid credit provided in section 27) provided for in this chapter shall be taken for the taxable year in which 'paid or accrued' or 'paid or incurred,' dependent upon the method of accounting upon the basis of which the net income is computed, unless in order to clearly reflect the income the deductions or credits should be taken as of a different period. In the case of the death

of a taxpayer whose net income is computed upon the basis of the accrual method of accounting, amounts (except amounts includible in computing a partner's net income under section 182) accrued as deductions and credits only by reason of the death of the taxpayer shall not be allowed in computing net income for the period in which falls the date of the taxpayer's death."

(26 U.S.C., § 43, ch. 1, 53 Stat. 24 (1939), as amended, ch. 619, 56 Stat. 830 (1942))

"SEC. 117. CAPITAL GAINS AND LOSSES.

* * * * * *

"(j) **Gains and losses from involuntary conversion and from the sale or exchange of certain property used in the trade or business.**

"(1) **Definition of property used in the trade or business.** For the purposes of this subsection, the term 'property used in the trade or business' means property used in the trade or business, of a character which is subject to the allowance for depreciation provided in section 23(l), held for more than 6 months, and real property used in the trade or business, held for more than 6 months, which is not (A) property of a kind which would properly be includible in the inventory of the taxpayer if on hand at the close of the taxable year, or (B) property held by the taxpayer primarily for sale to customers in the ordinary course of his trade or business, or (C) a copyright, a literary, musical, or artistic composition, or similar property, held by a taxpayer described in subsection (a)(1)(C). Such term also includes timber or coal with respect to which subsection (k)(1) or (2) is applicable and unharvested crops to which paragraph (3) is ap-

plicable. Such term also includes livestock, regardless of age, held by the taxpayer for draft, breeding, or dairy purposes, and held by him for 12 months or more from the date of acquisition. Such term does not include poultry.

"(2) **General rule.** If, during the taxable year, the recognized gains upon sales or exchanges of property used in the trade or business, plus the recognized gains from the compulsory or involuntary conversion (as a result of destruction in whole or in part, theft or seizure, or an exercise of the power of requisition or condemnation or the threat or imminence thereof) of property used in the trade or business and capital assets held for more than 6 months into other property or money, exceed the recognized losses from such sales, exchanges, and conversions, such gains and losses shall be considered as gains and losses from sales or exchanges of capital assets held for more than 6 months. If such gains do not exceed such losses, such gains and losses shall not be considered as gains and losses from sales or exchanges of capital assets. For the purposes of this paragraph—

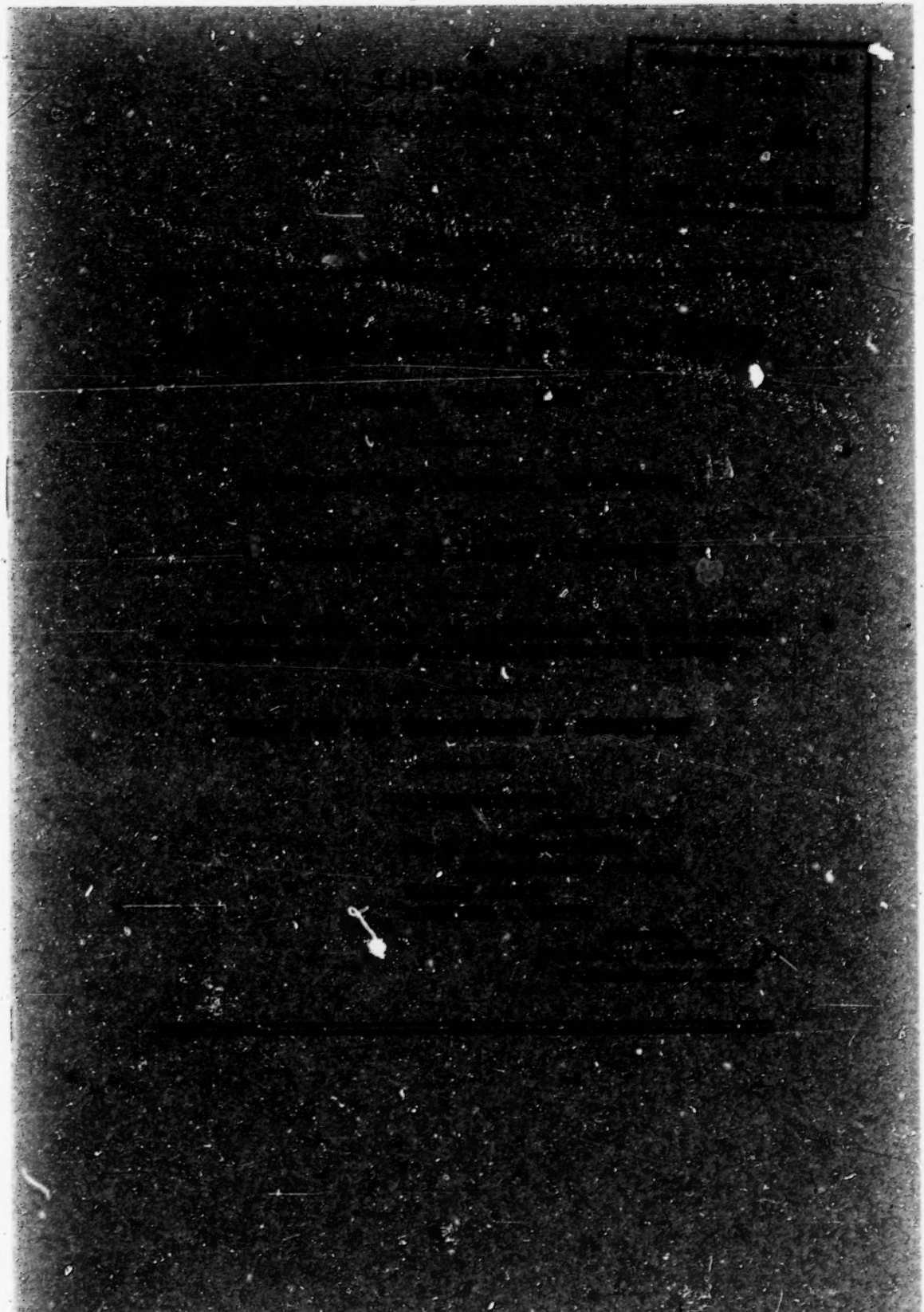
"(A) In determining under this paragraph whether gains exceed losses, the gains described therein shall be included only if and to the extent taken into account in computing gross income and the losses described therein shall be included only if and to the extent taken into account in computing net income, except that subsection (d) shall not apply.

"(B) Losses upon the destruction, in whole or in part, theft or seizure, or requisition or condemnation of property used in the trade or business or capital assets held for more than 6 months

shall be considered losses from a compulsory or involuntary conversion."

* * * * *

(26 U.S.C., § 117(j), added by ch. 619, 56 Stat. 846 (1942), as amended, ch. 63, 58 Stat. 47 (1944), as amended, ch. 994, 64 Stat. 933 (1950), as amended, ch. 521, 65 Stat. 500 (1951))



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In the Supreme Court of the United States

OCTOBER TERM, 1963

No. 656

AMERICAN CAN COMPANY, PETITIONER

v.

COMMISSIONER OF INTERNAL REVENUE

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SECOND CIRCUIT

BRIEF FOR THE RESPONDENT IN OPPOSITION

OPINIONS BELOW

The opinion of the Tax Court (R. 15–52) is reported at 37 T.C. 198. The opinion of the court of appeals (R. 165–170) is reported at 317 F. 2d 604.

JURISDICTION

The judgment of the court of appeals was entered on May 29, 1963. (R. 171–172.) The taxpayer's petition for rehearing (R. 173–190) was denied on July 8, 1963. (R. 191–198.) On October 1, 1963, the taxpayer's time for filing a petition for a writ of certiorari was extended by order of MR. JUSTICE HARLAN

to and including December 5, 1963. The petition for certiorari was filed on December 4, 1963. The jurisdiction of this Court is invoked under 28 U.S.C. 1254.

QUESTIONS PRESENTED

1. Whether the courts below erred in holding that the can-closing machines sold by the taxpayer during the taxable year in issue constituted property held primarily for sale to customers in the ordinary course of business within the meaning of Section 117 (a) and (j) of the Internal Revenue Code of 1939, and that the taxpayer's sales profits, therefore, were taxable as ordinary income and was not as capital gains.

2. Whether the taxpayer is entitled to change its method of accounting for vacation pay and state property tax expenses without first obtaining the Commissioner's agreement to such a change.

STATUTE AND REGULATIONS INVOLVED

Sections 41, 43, and 117(j) of the Internal Revenue Code of 1939 (26 U.S.C., 1952 ed.) are set forth at pages A1–A4 of the petition. Sections 39.41-2 and 39.43-2 of Treasury Regulations 118 (1939 Code) are set forth in relevant part in the Appendix to this brief, *infra*, pp. 13–15.

STATEMENT

Closing Machine Sales.—The taxpayer has been the nation's leading manufacturer of sanitary food and beverage containers ever since the early 1900's. It also manufactures can-closing machinery, and for many years it followed a policy of only leasing this equipment at a nominal rental so as to promote sales

of its containers. (R. 16–17, 166–167.) In 1949 this policy was judicially determined to be in violation of antitrust laws and subsequent proceedings were held to determine the appropriate remedy. The Government urged that a decree be entered ordering the complete divesture of the taxpayer's closing equipment operations. The taxpayer, however, sought a less drastic decree and offered to undertake a closing equipment sales program as part of its regular business operations. (R. 17–18, 167.) The taxpayer was successful in winning court approval of the alternative proposal, and in 1950 a decree was entered providing for a sales program under the supervision of a special master and the Department of Justice. (R. 18–22, 167.)

Following the entry of the antitrust decree, the availability of the taxpayer's machinery for purchase as well as lease was made known to the trade through notices to lessees and by advertisements. (R. 22, 27–28.) The taxpayer also continued to manufacture closing equipment and in the fall of 1950 it established a closing machine department, with three geographical divisions, which was responsible for the manufacture, design, leasing, sales and servicing of the equipment. (R. 24, 27.) In 1953, the taxable year in question, the taxpayer sold a total of 3,830 machines for a total recognized gain of $5,857,249.38. (R. 26.) Most of these machines were manufactured before the antitrust decree, but some were produced afterward. (R. 167.)

The taxpayer reported its total recognized gain from machinery sales in 1953 as long-term capital

gain. The Commissioner, however, determined that these profits were taxable as ordinary income, and the full Tax Court, one judge dissenting, sustained this determination. (R. 32–36, 46.) The court below affirmed this part of the Tax Court's decision. (R. 167–168.)

Accounting for Vacation Pay and Property Tax Expenses.—For all of its taxable years, up to and including 1953, the taxpayer accounted for and deducted employees' vacation pay and state property taxes in the taxable year in which such expenses were actually paid rather than in the year in which liabilities therefor accrued. Thus, on its 1953 return the taxpayer deducted the amounts of $5,853,970.70 and $1,596,751.42, which sums represented vacation pay and state tax expenses, respectively, the liabilities for which accrued in 1952 but which were paid by the taxpayer in 1953. (R. 29–31, 169.)

The taxpayer's liability for vacation payments made in 1954, in the amount of $6,889,165.34, and for 1954 state property taxes, in the amount of $1,659,773.59, accrued in 1953, but the taxpayer[1] claimed no deduction therefor in its 1953 income tax return. A claim for a deduction on account of these expenses, and of a resulting overpayment of income and excess profits taxes reported for 1953, was made by the taxpayer in its Tax Court petition for a re-

[1] In accordance with its prior method of accounting the taxpayer deducted these amounts on its 1954 return. (R. 29–31, 104–105.)

determination. (R. 30, 31.)[2] The taxpayer has never sought the Commissioner's consent to this change in its method of accounting for vacation pay and state tax expenses. (R. 29, 169.)

The Tax Court (R. 36–46), with four judges dissenting (R. 46–52), allowed the accounting change sought by the taxpayer, but the court below reversed (R. 169–170.)

ARGUMENT

The Court of Appeals correctly applied the law to the particular facts of this case. There is no conflict of decisions and no other cause for review.

1. Under the Internal Revenue Code gains from the sale or exchange of capital assets are taxed at preferential tax rates. Sections 117 (a) and (j) of the Internal Revenue Code of 1939 expressly exclude from the category of capital assets "property held by the taxpayer primarily for sale to customers in the ordinary course of his trade or business" (Pet. A2), and thus gains from such property are taxed at ordinary income rates. As the two courts below determined, this case falls squarely within the exclusion from the statutory definition of capital assets.

There is no doubt that prior to the antitrust proceeding the taxpayer's business policy was to lease its can-closing equipment as an inducement to customers to purchase its line of food and beverage containers.

[2] The parties have stipulated that if the taxpayer is allowed the claimed deductions, the sums actually deducted by the taxpayer on its 1953 return shall be disallowed. (R. 30–31.)

(R. 17, 167.) And, as the courts below recognized (R. 35, 168), there is also no doubt that had the taxpayer been willing to divest itself of the closing equipment branch of its business—as the Government had urged as a proper remedy for the taxpayer's violation of the antitrust laws (R. 17–18, 167)—it would have been entitled to report its net liquidation proceeds as capital gains. See *Smith* v. *Commissioner*, 232 F. 2d 142 (C.A. 5th). But the taxpayer would not agree to a divesture order and, instead, it sought and obtained permission to undertake a sales program relating to its can-closing machinery. To this end, the taxpayer set up a sales department, advertised the availability of its machines for sale, and continued to manufacture can-closing equipment. (R. 24, 27, 28, 167.) Thereafter, as the courts below held, the taxpayer held the closing equipment for sale as part of its regular and ordinary business.

Nor is the reason why the taxpayer adopted its new method of doing business important. *Ehrman* v. *Commissioner*, 120 F. 2d 607, 610 (C.A. 9th), certiorari denied, 314 U.S. 668. What matters is that by choosing not to accept the divesture order and by deciding to continue in the closing-equipment business knowing that the machinery would have to be offered for sale, the taxpayer put itself in the dual business of selling as well as renting closing equipment. *S. E. C. Corp.* v. *United States*, 241 F. 2d 416 (C.A. 2d), affirming *per curiam*, 140 F. Supp. 717 (S.D.N.Y.), certiorari denied, 354 U.S. 909; *Rollingwood Corp.* v. *Commis-*

sioner, 190 F. 2d 263, 266 (C.A. 9th); *Recordak Corp. v. United States* (Ct. Cl. No. 455–59), decided December 13, 1963. The closing equipment sold in 1953 was held with the substantial purpose of sale to customers in the ordinary course of the taxpayer's business, and the courts below did not err in so holding.

2. Section 41 of the Internal Revenue Code of 1939 (Pet. A1) provides that the net income of a taxpayer shall be computed upon the basis of the taxpayer's annual accounting period in accordance with the method of accounting regularly employed by such taxpayer in keeping his books, unless the Commissioner determines that the method the taxpayer employs does not clearly reflect income. The present taxpayer employed the accrual method of accounting (R. 29) except that each year it consistently deducted employees' vacation pay and certain state property taxes when these expenses were actually paid and not in the preceding year when the liabilities therefor accrued (R. 29, 30–31). This method of deducting such expenses was not in accord with a true accrual system of accounting (R. 169), but it had never been questioned by the Commissioner, who had accepted the taxpayer's tax returns filed on that basis.

Changes in the method of accounting employed by a taxpayer are governed by the regulations. Section 39.41–2(*c*) of the regulations (Regs. 118 (1939 Code), Appendix, *infra*, pp. 13–14), provides that a taxpayer

who changes "the method of accounting employed in keeping his books" must secure the prior consent of the Commissioner, that a change in the method of accounting includes "any change in the accounting treatment of items of income or deductions," that application must be made to the Commissioner for permission to make the change, and that such permission "will not be granted unless the taxpayer and the Commissioner agree to the terms and conditions under which the change will be affected." An interpretive Revenue Ruling provides that the requirement that the Commissioner's consent be obtained applies to a change in treatment of any "material item", and "whether or not the taxpayer regards the method from which he desires to change to be proper." (Rev. Rul. 59-285, 1959-2 Cum. Bull. 458, 459-460).[1] The taxpayer here has attempted to change its consistent treatment of two significant and material items. Its action in this respect is a change in its method of accounting within the meaning of the applicable Treasury Regulations and Revenue Ruling, and that is true even if its former consistent method of deducting the expenses in question was not correct under the accrual accounting system. *Wright Contracting Co. v. Commissioner*, 316 F. 2d 249, 254 (C.A. 5th).

[1] In the 1954 Code, the requirement of consent to any change of accounting methods, formerly found only in the regulations, was written into the statute (§ 446(e)). The regulations, in turn, now expressly provide that any change "in the treatment of a material item" is a change of method and that consent must be obtained regardless of the propriety of the prior method (Regs. (1954 Code), § 1.446-1(e)(2)(ii)).

certiorari denied, 375 U.S. 879; *Commissioner* v. *O. Liquidating Corp.*, 292 F. 2d 225, 230–231 (C.A. 3d), certiorari denied, 368 U.S. 898; *Advertisers Exchange, Inc.* v. *Commissioner*, 25 T.C. 1086, affirmed *per curiam*, 240 F. 2d 958 (C.A. 2d).

The court of appeals did not hold that the taxpayer will never be able to conform its system of accounting for the material items in question to a strict accrual method. In accordance with the Commissioner's position before that court and before the Tax Court, the appellate court has merely held that the matter must first be taken up with the Commissioner, who will then be in a position to protect the government's interests. (R. 169–170.) The propriety of this determination is apparent in view of the purpose of the regulation requiring not only the consent of the Commissioner to a change in accounting method, but also an accompanying agreement as to the terms and conditions under which the change will be effected. The regulation seeks to remedy the distortion of income (to the detriment of the government) which results from "virtually any material change in the method of reporting income or deduction items". *Commissioner* v. *O. Liquidating Corp.*, *supra*, p. 230; see also *Kahaku Plantation Co.* v. *Commissioner*, 132 F. 2d 671 (C.A. 9th). When consulted in the first instance, the Commissioner may remedy the distortion brought about by the proposed change by withholding his consent until the taxpayer agrees to adjustments designed to prevent omission of income items or a duplication or bunching of

deduction items as a result of the change.' See *Brookshire* v. *Comissioner*, 273 F. 2d 638 (C.A. 4th), certiorari denied, 363 U.S. 827.

The taxpayer alleges conflict with (Pet. 21) a "long line of Supreme Court cases", especially *United States* v. *Consolidated Edison Co.*, 366 U.S. 380, and *United States* v. *Anderson*, 269 U.S. 422. None of the cases cited by the taxpayer or by the Tax Court majority, however, involved the question of a taxpayer's right to change a consistent method of accounting without the Commissioner's consent. As the court below pointed out (R. 169), in the *Consolidated Edison Co.* case the Commissioner raised only the question of the proper year of accrual of the item under general accrual principles and did not oppose the taxpayer's change of treatment—which caused no bunching—should the taxpayer be correct as to the time of accrual.[4] And the *Anderson* case did not

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[3] In this case the accounting change proposed by the taxpayer would result in a distortion caused by the bunching of expenses for the taxable year 1952. According to the stipulation of the parties (R. 104, 105), the 1953 expenses disallowed by the Tax Court would be allowed for 1952, that being the year in which those expenses actually accrued. That procedure would bunch two years' expenses in 1952—both the deduction actually taken on the cash basis and the one that accrued in 1952 but which was taken in 1953. The taxpayer has not agreed to terms and conditions which would alleviate this distortion, a distortion that is particularly significant because 1952 was an excess-profits-tax year.

[4] *Consolidated Edison* presented only "the very narrow issue" (366 U.S. at p. 387) whether the remittance by an accrual basis taxpayer of a contested state tax assessment constituted "payment" of the contested part of the assessment, so as to render it accruable in the year of remittance, or whether liability for the tax accrued in the later year when the con-

involve a change from a consistent method of accounting even on its facts. The sole question there was the proper year of accrual (1916 or 1917) of an expense item under the Revenue Act of 1916, 39 Stat. 756, Section 13(d), which for the first time authorized use of the accrual system.[8]

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test was terminated. The Court's opinion is to be searched in vain for any discussion, much less a holding, regarding a taxpayer's right unilaterally to change his method of accounting.

[8] Although it is apparently not relied upon by the taxpayer as a basis for certiorari (see Pet. 19), *Beacon Publishing Co.* v. *Commissioner*, 218 F. 2d 697 (C.A. 10), is arguably in conflict with the decision below. That case may be distinguished, however, on the ground that the change involved there did not result in a bunching of deductions nor any overall avoidance of taxes, while the change sought here would result in the bunching of two years' deductions in an excess-profits-tax year (1952). See 218 F. 2d at 702. The *Beacon Publishing* case, moreover, was the first case to consider the issue; the opinion discussed the question only briefly; and all of the later cases have rejected its holding. *Advertisers Exchange, Inc.* v. *Commissioner*, 240 F. 2d 958 (C.A. 2), affirming 25 T.C. 1086; *Commissioner* v. *O. Liquidating Corp.*, 292 F. 2d 225, 230–231 (C.A. 3), certiorari denied, 368 U.S. 898; *Wright Contracting Co.* v. *Commissioner*, 316 F. 2d 249, 254 (C.A. 3), certiorari denied, 375 U.S. 879. Additionally, the legal context of the question has been significantly changed under the 1954 Code, since the requirement of consent has now been written into the statute, and the regulations now expressly require that consent be obtained regardless of the propriety of the treatment sought to be changed (see note 3, *supra*). In view of the weight of the opposing authority and the incorporation of the rules into the statute and regulations, there is a substantial likelihood that the Tenth Circuit, if faced with the question again, would now acquiesce in the majority view, thereby eliminating whatever conflict may be said to exist. This Court denied certiorari in the *O. Liquidating Corp.* case despite an asserted conflict with *Beacon Publishing*, and there is even less reason now to review the question.

CONCLUSION

The decision below is correct, and, for the reasons stated, the petition for certiorari should be denied.

Respectfully submitted.

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JANUARY 1964.

APPENDIX

Treasury Regulations 118 (1939 Code):

SEC. 39.41-2 *Bases of computation and changes in accounting methods.*—(a) Approved standard methods of accounting will ordinarily be regarded as clearly reflecting income. A method of accounting will not, however, be regarded as clearly reflecting income unless all items of gross income and all deductions are treated with reasonable consistency. * * *.

(b) The true income, computed under the Internal Revenue Code and, if the taxpayer keeps books of account, in accordance with the method of accounting regularly employed in keeping such books (provided the method so used is properly applicable in determining the net income of the taxpayer for purposes of taxation), shall in all cases be entered in the return. If for any reason the basis of reporting income subject to tax is changed, the taxpayer shall attach to his return a separate statement setting forth for the taxable year and for the preceding year the classes of items differently treated under the two systems, specifying in particular all amounts duplicated or entirely omitted as the result of such change.

(c) A taxpayer who changes the method of accounting employed in keeping his books shall, before computing his income upon such new method for purposes of taxation, secure the consent of the Commissioner. For the purposes of this section, a change in the method of accounting employed in keeping books means any change in the accounting treatment of items of income or deductions, such as a change from

cash receipts and disbursements method to the accrual method, or vice versa; a change involving the basis of valuation employed in the computation of inventories (see §§ 39.22(c)-1 to 39.22(c)-8, inclusive); a change from the cash or accrual method to the long-term contract method, or vice versa; a change in the long-term contract method from the percentage of completion basis to the completed contract basis, or vice versa (see § 39.42-4); or a change involving the adoption of, or a change in the use of, any other specialized basis of computing net income such as the crop basis (see §§ 39.22(a)-7 and 39.23(a)-11. Application for permission to change the method of accounting employed and the basis upon which the return is made shall be filed within 90 days after the beginning of the taxable year to be covered by the return. The application shall be accompanied by a statement specifying the classes of items differently treated under the two methods and specifying all amounts which would be duplicated or entirely omitted as a result of the proposed change. Permission to change the method of accounting will not be granted unless the taxpayer and Commissioner agree to the terms and conditions under which the change will be effected. See section 22(d) and §§ 39.22(d)-1 to 39.22(d)-7, inclusive, with respect to changing to the last-in first-out method of inventorying goods.

* * * * * * *

SEC. 39.43-2 *When charges deductible.*— * * *. A taxpayer has the right to deduct all authorized allowances and it follows that if he does not within any year deduct certain of his expenses, losses, interest, taxes, or other charges, he cannot deduct them from the income of the next or any succeeding year. It is recognized, however, that particularly in a going business of any magnitude there are cer-

tain overlapping items both of income and deduction, and so long as these overlapping items do not materially distort the income they may be included in the year in which the taxpayer, pursuant to a consistent policy, takes them into his accounts. * * *.

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Petitioner,

v.

COMMISSIONER OF INTERNAL REVENUE,
Respondent.

On Petition for a Writ of Certiorari to the United States Court of Appeals for the Second Circuit

PETITIONER'S REPLY BRIEF

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PETITIONER'S REPLY BRIEF

The Accrual Issue

In opposing the petition for a writ of certiorari on the accrual issue, Respondent asserts that the question presented is whether the taxpayer is entitled to change its method of accounting without first obtaining the Commissioner's agreement to such a change. But that is not the question here. Rather, the question is whether the Commissioner may require an accrual basis taxpayer to deduct vacation pay and certain property tax expenses in a year other than the year in which such expenses accrued, where the taxpayer had in prior years deducted similar expenses in the wrong period. The taxpayer agrees, of course, that the

Commissioner's prior consent would be required if the taxpayer were seeking to change its method of accounting. The taxpayer, however, seeks not to change its method of accounting but only to apply its method of accounting to certain items of expense which had been erroneously treated in prior years. See *United States v. American Can Co.*, 280 U.S. 412 (1930).

As stated in the Petition (pp. 17-18), the rationale of the requirement that a taxpayer must obtain the Commissioner's permission before making a change in its method of accounting is that a change in method of accounting will in general result in the permanent omission of items of income or the allowance of two deductions for the same item of expense. To protect the revenue from such "distortion of income," the Commissioner may withhold his consent until the taxpayer agrees to adjustments that will prevent duplication of deduction items or omission of income items as a result of the change.* *Brookshire v. Commissioner*, 273 F.2d 638 (4th Cir.), *cert. denied*, 363 U.S. 827 (1960). See also Treas. Reg. 118, § 39.41-2(c).

Unlike the case of a change in method of accounting, however, no "distortion of income" can result from

* For example, if a cash basis taxpayer were to change its method of accounting to the accrual basis, income earned in the year before the change and received in the year of the change would, without adjustments, not properly be includible in taxable income in either of such years. Similarly, if an accrual basis taxpayer were to change its method of accounting to the cash basis, an expense which accrued in the year before the change and was paid in the year of the change would, without adjustments, be properly deductible in both years. Consequently, in order to prevent such omissions or duplications, the Commissioner is given the power to demand appropriate adjustments as a condition of allowing a taxpayer to change its method of accounting. See Treas. Reg. 118, § 39.41-2(c); see also Int. Rev. Code of 1954, § 481.

the correction of an error because in such case there is no possibility that an item of income may properly be omitted from the computation of taxable income or that an item of expense may properly be the source of more than one deduction. If, under a taxpayer's method of accounting, an item is properly taken into account in one year, it is by hypothesis improper to take the same item into account in any other year. Correction of any other year in which the item may have been improperly included or deducted is open, apart from the statute of limitations, either to the taxpayer or to the Commissioner, as the case may be. Therefore, the reason for the rule requiring the consent of the Commissioner to a change in method of accounting does not exist in the case of the correction of an error.

Respondent implies (Brief, pp. 9-10) that the purpose of the regulation requiring the Commissioner's prior consent is to prevent not only the omission of income and the duplication of deductions but also the "bunching of deduction items." As shown in the Petition (pp. 17-18), however, it is clear under Treasury Regulation 118, § 39.41-2(c) that the Commissioner is concerned only with preventing the omission of income and the duplication of deductions.* Moreover, although Respondent argues that in the present case the correction sought by the taxpayer "would branch two years' expenses in 1952," it is apparent that the bunching

* See also section 481 of the Internal Revenue Code of 1954 which restricts the adjustments the Commissioner can make in the case of a change in method of accounting to those designed to prevent amounts "from being duplicated or omitted." Moreover, it should be noted that adjustments required by the Commissioner as a condition of making a change in accounting method cause, rather than prevent, the bunching of income or deduction items.

referred to by Respondent results only from the taxpayer's being entitled to an adjustment which has the effect of allowing the taxpayer to deduct in 1952, a year otherwise barred by the statute of limitations, the expenses that accrued in that year as well as those that were paid in that year. Such adjustment is specifically required by sections 1311-15 of the Internal Revenue Code of 1954 which provide a method of adjustment where the correction of an error would otherwise be prevented by the statute of limitations.*

The adjustment under sections 1311-15 does not allow the taxpayer more than one deduction for a single item of expense. Indeed, if the adjustment were not

* Sections 1311-15 provide, among other things, that if (i) a decision of the Tax Court disallows a deduction which should have been allowed to, but was not allowed to, the taxpayer for another taxable year, (ii) the correction of the error is prevented by the statute of limitations, and (iii) refund of the overpayment attributable to the deduction which should have been allowed was not barred by the statute of limitations at the time the taxpayer first maintained before the Commissioner that he was entitled to such deduction (e. g., by claiming it in his tax return for a later year), then the "effect of the error" shall be corrected by an adjustment. The adjustment is defined as the decrease in tax which results solely from the correct treatment of the deduction, i. e., the amount of the adjustment shall not be diminished by any set-off based upon any item other than the one which was the subject of the adjustment. These sections reflect the intent of Congress to correct an error by making an adjustment in only one year rather than in each of the prior years.

The applicability of sections 1311-15 to the facts in the present case was acknowledged by the Commissioner in Revenue Ruling 57-13, 1957-1 Cum. Bull. 552, and in Revenue Ruling 58-21, 1958-1 Cum. Bull. 318, which states:

"The allowance of the deduction in the year 1952 for vacation pay disallowed for 1953 results in a pyramiding of vacation pay deductions in 1952 one on the cash method, attributable to 1951, and one on the accrual method. Despite this result, section 1314(c) of the Code provides that the amount to be refunded or credited in the same manner as an overpayment shall not be diminished by any credit or set-off based upon any item other than the one which was the subject of the adjustment."

made, the taxpayer would be permanently denied a deduction for the vacation pay and property tax expenses that accrued in 1952.* The provisions of sections 1311-15 were included in the Code specifically to deal with situations, such as the present case, where no omission or duplication of items is involved, but where the statute of limitations would otherwise preclude an adjustment resulting from the correction of an error. For that reason, Congress made the operation of these sections mandatory and not subject to the Commissioner's consent.

The adjustments provided in sections 1311-15 are available to both the Commissioner and the taxpayer. Thus, in *United States v. Consolidated Edison Co.*, 366 U.S. 380 (1961), holding that the taxpayer was entitled to correct its erroneous treatment of property taxes, this Court noted that the Commissioner would be entitled to an adjustment under sections 1311-15 with respect to the deductions erroneously taken in prior years otherwise closed by the statute of limitations.

Although Respondent asserts (Brief, p. 10) that there was "no bunching" in *Consolidated Edison*, the fact is that the decision of this Court resulted in reducing the income of a single year by approximately

* The Government states (Brief, p. 10, fn. 4) that the so-called "distortion" resulting in the present case from the adjustment permitted by sections 1311-15 "is particularly significant because 1952 was an excess-profits tax year". The implication is that the taxpayer is seeking to obtain an advantage from the expense deductions by using them to offset income taxable at excess profits tax rates rather than at ordinary corporate rates. However, as counsel for the Government conceded on oral argument in the court below the taxpayer was not subject to excess profits tax in 1952 and so could not have had the motive attributed to it.

$13,000,000, which reduction would otherwise have been spread over a five-year period. (See Petition, p. 19, fn.) Respondent also attempts (Brief, p. 10) to avoid the controlling effect of the decision in the *Consolidated Edison* case on the ground that it did not involve "the question of a taxpayer's right to change a consistent method of accounting without the Commissioner's consent." Neither, of course, does this case. Moreover, in the *Consolidated Edison* case, as in the present case, the taxpayer had for many years deducted in its tax returns the item of expense in question in the year of payment rather than in the year of accrual. Notwithstanding such long-continued "treatment of a material item," this Court applied the rule that "neither the Government nor an accrual basis taxpayer may cause an item to be deducted in a year other than the one in which it accrued." (366 U.S. 380, at p. 385)

In sum, the decision of the Court of Appeals in the present case cannot be reconciled with this Court's decision in *Consolidated Edison* or the long line of Supreme Court decisions cited therein. Accordingly, Petitioner urges that a writ of certiorari be granted with respect to this issue.

The Capital Gain Issue

The brief for Respondent does not deal with either of the questions presented under section 117(j) of the Internal Revenue Code of 1939, viz: (1) whether the statutory phrase "held by the taxpayer primarily for sale" applies to property which is held principally, chiefly or predominantly for a purpose other than sale,

and (2) whether the statutory phrase "in the ordinary course of [a taxpayer's] trade or business" applies to the sale of property held for many years solely for use in a taxpayer's trade or business and ultimately sold only because of the mandatory provisions of an anti-trust decree, at prices fixed by the decree that had no relation to the value of the property.

It is respectfully submitted that, for the reasons stated in the Petition, these questions should be decided by this Court.

Conclusion

For the foregoing reasons, the petition for a writ of certiorari should be granted.

Respectfully submitted,

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